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INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, LMSB, AREA 1
(LM:FSH:HAR)

FROM: Mark Pitzer, Senior Counsel, Branch 6, Office of
Passthroughs and Special Industries, CC:PSI:6

SUBJECT: Proper asset guideline class for tools, dies, and molds used
by the taxpayer in manufacturing its products, and
whether a change in the asset guideline class of Rev. Proc.
87-56 for these assets is a method change under section
446

This Chief Counsel Advice responds to your memorandum dated May 23, 2002. In accordance with section 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =

Taxable Years =

Amount =

ISSUES

1. Whether the tools, dies, and molds used by Taxpayer in manufacturing its products are includible in asset class 30.21, Manufacture of Finished Plastic Products—Special Tools, or asset class 39.0, Manufacture of Athletic, Jewelry, and Other Goods, of Rev. Proc. 87-56, 1987-2 C.B. 674.

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2. Whether a change in recovery period resulting from a change in MACRS classification of Taxpayer's tools, dies, and molds is a change in method of accounting to which the provisions of section 446 of the Internal Revenue Code and the regulations thereunder apply.

CONCLUSIONS

1. The tools, dies, and molds used by Taxpayer in manufacturing its products are includible in asset class 39.0 of Rev. Proc. 87-56 because Taxpayer is engaged in the business activity of manufacturing but is not engaged in the business activity of manufacturing finished plastic products.

2. A change in recovery period resulting from a change in MACRS classification of Taxpayer's tools, dies, and molds from asset class 30.21 to asset class 39.0 is a change in method of accounting to which the provisions of section 446 and the regulations thereunder apply because the change in classification affects the proper time that Taxpayer can take depreciation deductions.

FACTS

Taxpayer is in the business of designing, manufacturing and marketing a diverse line of products. Generally, Taxpayer uses various materials to construct its products, including plastic, metal, wood, cardboard, and cloth. Taxpayer also utilizes numerous tools, dies, and molds (the "disputed assets") in its manufacturing process. Taxpayer's manufacturing process includes injection molding, blow molding, metal stamping, printing, box making, assembly, and wood processing.

During Taxable Years, Taxpayer spent Amount on the disputed assets. Taxpayer utilizes the disputed assets to produce plastic products and parts. Taxpayer makes its own tools but purchases the dies and molds from third parties. For tax purposes, Taxpayer has historically classified the disputed assets in asset class 30.21, Manufacture of Finished Plastic Products – Special Tools, of Rev. Proc. 87-56. Taxpayer depreciates the remainder of its tangible personal property under asset class 39.0, Manufacture of Athletic, Jewelry and Other Goods.

The Internal Revenue Service is currently examining the consolidated income tax returns of Taxpayer for Taxable Years. During this examination, the Service advised Taxpayer that, because Taxpayer is a plastic manufacturer, the disputed assets are includible in asset class 39.0 rather than asset class 30.21. Taxpayer contends that the disputed assets belong in asset class 30.21 because Taxpayer uses them to produce finished plastic products.

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LAW AND ANALYSIS

Issue 1

The depreciation deduction provided by section 167(a) for tangible property placed in service after 1986 generally is determined under section 168. This section prescribes two methods of accounting for determining depreciation allowances: (1) the general depreciation system in section 168(a); and (2) the alternative depreciation system in section 168(g). Under either depreciation system, the depreciation deduction is computed by using a prescribed depreciation method, recovery period, and convention.

For purposes of either section 168(a) or 168(g), the applicable recovery period is determined by reference to class life or by statute. Section 168(i)(1) provides that the term "class life" means the class life (if any) that would be applicable with respect to any property as of January 1, 1986, under former section 167(m) as if it were in effect and the taxpayer were an elector. Prior to its revocation, section 167(m) provided that in the case of a taxpayer who elected the asset depreciation range system of depreciation (ADR), the depreciation deduction would be computed based on the class life prescribed by the Secretary which reasonably reflects the anticipated useful life of that class of property to the industry or other group.

Section 1.167(a)-11(b)(4)(iii)(b) of the Income Tax Regulations sets out the method for asset classification under former section 167(m). Property is included in the asset guideline class for the activity in which the property is primarily used. Property is classified according to primary use even though the use is insubstantial in relation to all of the taxpayer's activities.

Rev. Proc. 87-56 sets forth the class lives of property that are necessary to compute the depreciation allowances under section 168. The revenue procedure establishes two broad categories of depreciable assets: (1) asset classes 00.11 through 00.4 that consist of specific assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of assets used in specific business activities. The same item of depreciable property can be described in both an asset category (that is, asset classes 00.11 through 00.4) and an activity category (that is, asset classes 01.1 through 80.0), in which case the item is classified in the asset category unless specifically described in the activity category. See Norwest Corporation & Subsidiaries v. Commissioner, 111 T.C. 105 (1998) (item described in both an asset and an activity category (furniture and fixtures) should be placed in the asset category). The asset classes described below are set forth in Rev. Proc. 87-56.

Asset class 30.2, Manufacture of Finished Plastic Products, includes assets used in the manufacture of plastics products and the molding of primary plastics for the

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trade. The asset class does not include assets used in the manufacture of basic plastics materials nor the manufacture of phonograph records. Assets in this class have a recovery period of 7 years for purposes of section 168(a) and 11 years for purposes of section 168(g).

Asset class 30.21, Manufacture of Finished Plastic Products -- Special Tools, includes assets defined as special tools, such as jigs, dies, fixtures, molds, patterns, gauges, and specialty transfer and shipping devices, used in activities as defined in class 30.2. Special tools are specifically designed for the production or processing of particular parts and have no significant utilitarian value and cannot be adapted to further or different use after changes or improvements are made in the model design of the particular part produced by the special tools. This asset class does not include general purpose small tools such as wrenches and drills, both hand and power-driven, and other general purpose equipment such as conveyors, transfer equipment, and materials handling devices. Assets in this class have a recovery period of 3 years for purposes of section 168(a) and 3.5 years for purposes of section 168(g).

Asset class 39.0, Manufacture of Athletic, Jewelry and Other Goods, includes assets used in the production of jewelry; musical instruments; toys and sporting goods; motion picture and television films and tapes; and pens, pencils, office and art supplies, brooms, brushes, caskets, etc. Assets in this class have a recovery period of 7 years for purposes of section 168(a) and 12 years for purposes of section 168(g).

The depreciation regime established by section 168, commonly referred to as "MACRS," is a class life depreciation regime. Under a class life depreciation regime the economic or useful life of a particular asset is not determinative of its recovery period. Rather, an asset's recovery period generally is determined by reference to the appropriate asset class.

The asset classes set forth in Rev. Proc. 87-56 are composite classes of assets. Each asset class includes assets that have longer or shorter anticipated useful lives than the recovery period provided for the asset class. With the exception of the assets that are includible in the asset classes provided for certain specific assets used in all business activities, assets generally are classified for depreciation purposes in accordance with the taxpayer's business activity. Thus, with respect to this latter category of assets, the focus of a classification inquiry is on the taxpayer's business activity rather than the particular asset.

The business activity asset classes were established in light of the recognition that the anticipated useful lives of assets, including the same types of assets, will vary in accordance with the business activity in which they are used. This is because each business activity has its own set of risks, business practices, and

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obsolescence realities. Taxpayers in a particular industry will tend to move toward similar production processes, use similar equipment, and retire equipment on similar schedules. See generally, The Adoption of the Asset Depreciation Range (ADR) System, Department of the Treasury (June, 1971). By providing that the class life of property reflects the anticipated useful life of that class of property to the industry or other group, former section 167(m) took cognizance of the different business circumstances of different businesses. Accordingly, under MACRS it is not uncommon for the same types of assets to have different recovery periods resulting from their inclusion in different business activity asset classes. For example, a fork-lift truck used in manufacturing rubber products (asset class 30.1) will have a 7-year recovery period under section 168(a) while the same fork-lift truck used in manufacturing chemicals (asset class 28.0) will have a 5-year recovery period under section 168(a).

Because of the reference to former section 167(m) in section 168(i)(1), MACRS classification determinations are guided by the ADR classification regulations. In addition, published guidance interpreting the ADR classification regulations is useful when considering classification questions under MACRS.

Section 1.167(a)-11(b)(4)(iii)(b) clearly indicates that a taxpayer can be engaged in multiple business activities. In such a case, assets are included in the asset class for the business activity in which the assets are primarily used. The regulation provides that assets are classified according to primary use even though the use is insubstantial in relation to all of the taxpayer's business activities. The issue presented by the present case is whether Taxpayer, in addition to being a manufacturer, a business activity described in asset class 39.0, is also engaged in the business of manufacturing finished plastic products, the business activity described in asset class 30.2. Only if Taxpayer is also engaged in the business of manufacturing finished plastic products can the disputed assets be included in asset class 30.21. This subsidiary asset class provides that it is limited to assets used in activities as defined in asset class 30.2. In addition, Rev. Proc. 74-30, 1974-2 C.B. 483, which was published to prescribe the subsidiary asset classes for ADR, provides that unless a subsidiary asset class has been established for an activity as set forth in Rev. Proc. 74-30 or other supplementary guidance, special tools placed in service after December 31, 1973, must be included with other machinery and equipment in the general activity asset class.

Rev. Rul. 77-63, 1977-1 C.B. 60, considered whether the chemical process assets of the taxpayer, a bauxite refiner and aluminum producer, should be classified separately from the assets used in the taxpayer's business activity of nonferrous metal manufacturing, the business activity described in asset class 33.2. The revenue ruling holds that because the taxpayer's chemical process is an integral part of the refining of the nonferrous metal, all of the assets used by the taxpayer in the processing of the bauxite ore into primary aluminum are classified in asset class

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33.2. The revenue ruling also holds that assets used in activities other than aluminum production should be classified in other asset classes.

Rev. Rul. 77-476, 1977-2 C.B. 5, holds that a 50-mile oil pipeline owned by an electric utility company used to transport oil between the company's dock and its inland generating facility is included in asset class 49.13, Electric Utility Steam Production Plant, rather than in asset class 46.0, Pipeline Transportation, because the company operated the pipeline in conjunction with its business activity of producing electrical energy. The revenue ruling concludes that the company does not have a separate trade or business activity of transporting oil or other goods by pipeline because the oil pipeline property is merely a part of the company's fuel handling operation for its electric generating plant.

Another source of insight into the content of the asset classes described in Rev. Proc. 87-56 is the Standard Industrial Classification Manual (SIC) published by the Office of Management and Budget. SIC is the statistical classification standard underlying all establishment-based Federal economic statistics classified by industry. However, in making use of SIC in a depreciation classification inquiry, care must be exercised because SIC does not use the same classification techniques and depreciation concepts of Rev. Proc. 87-56. While SIC has precise categorization by primary business activity using language and a numbering scheme very similar to that found in Rev. Proc. 87-56, the revenue procedure departs dramatically from the categorization scheme of SIC by establishing, as previously discussed, two broad categories of depreciable assets: (1) asset classes 00.11 through 00.4 that consist of specific assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of assets used in specific business activities.

The Introduction to the 1987 SIC provides that an establishment is an economic unit, generally at a single physical location, where business is conducted or where services or industrial operations are performed. Where distinct and separate economic activities are performed at a single physical location, each activity should be treated as a separate establishment where: (1) no one industry description in the classification includes such combined activities, (2) the employment in each such economic activity is significant, and (3) separate reports can be prepared on the number of employees, their wages and salaries, sales or receipts, and other types of establishment data.

SIC Major Group 39, Miscellaneous Manufacturing Industries, includes establishments primarily engaged in manufacturing products not classified in any other manufacturing major group. Industry No. , includes establishments primarily engaged in manufacturing . Industry No. , includes establishments primarily engaged in manufacturing

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, and . Products of this industry include, among many other things,

The revenue rulings discussed above indicate that the MACRS asset classification system looks at business activities broadly and is not intended to divide a taxpayer's business into a myriad of activities. This view comports with the introductory language in SIC indicating that a business will be subdivided for SIC classification purposes only where separate and distinct economic activities are performed, no one industry description in the classification includes such combined activities, and employment in each activity is significant. In this regard it is clear that under SIC manufacturers of

are encompassed within Major Group 39.

Accordingly, for an activity to be classified as a separate business activity for MACRS purposes, it must be substantial (although it may be insubstantial in relation to all the activities of the taxpayer), significant, and separate, and not merely part of another business activity of the taxpayer.

The present case is similar to the situations described in the revenue rulings discussed above. Taxpayer is a manufacturer of . Taxpayer's are manufactured from, among other materials, metal, wood, plastic, cardboard, and combinations thereof. All of the plastic products produced by Taxpayer are used in conjunction with, and are integral to, Taxpayer's manufacturing business activity. Like the chemical process assets at issue in Rev. Rul. 77-63 and the oil pipeline assets at issue in Rev. Rul. 77-476, the disputed assets in the present case are merely part of another business activity, in this case manufacturing. The disputed assets are not used in conjunction with any other activity; rather, the activities performed by the disputed assets are encompassed within the description of asset class 39.0. Taxpayer does not have a separate business activity of manufacturing finished plastic products. Accordingly, the disputed assets are not includible in asset class 30.21 and must be classified in asset class 39.0.

Issue 2

Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

Section 446(b) provides that if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

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Section 446(e) provides that, except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary.

Section 1.446-1(a)(1) defines the term “method of accounting” as including not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for, among other things, depreciation.

Section 1.446-1(e)(2)(ii)(a) provides that a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction.

Section 1.446-1(e)(2)(ii)(b) provides that a change in method of accounting does not include an adjustment with respect to the addition to a reserve for bad debts or an adjustment to the useful life of a depreciable asset. The regulation further provides that while these adjustments may involve the question of the proper time for the taking of a deduction, these items are traditionally corrected by adjustments in the current and future years.

In the present case, the Service is reclassifying the disputed assets from asset class 30.21 to asset class 39.0 of Rev. Proc. 87-56. Assets includible in asset class 30.21 have a recovery period of 3 years for purposes of section 168(a) and 3.5 years for purposes of section 168(g). Assets includible in asset class 39.0 have a recovery period of 7 years for purposes of section 168(a) and 12 years for purposes of section 168(g). This change in classification changes the recovery period of the disputed assets, but not the depreciation method and convention.

Under MACRS, the recovery period determines the period of time over which the basis of depreciable property is recovered. A change in recovery period affects when, not whether, the cost of depreciable property will be deducted. Thus, the change in classification of the disputed assets from asset class 30.21 to asset class 39.0 changes the applicable recovery period and, consequently, the proper time that Taxpayer can take depreciation deductions. While section 1.446-1(e)(2)(ii)(a) indicates that a change in the treatment of any item which involves the proper time for the taking of a deduction is a change in method of accounting, section 1.446-1(e)(2)(ii)(b) provides that a change in method of accounting does not include an adjustment to the useful life of a depreciable asset. The question presented by the

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present case is whether a change in recovery period falls within the scope of the “useful life exception” of section 1.446-1(e)(2)(ii)(b) or whether such change is a change in method of accounting.

“Useful life” and “recovery period” are not equivalent terms and significant differences exist between these depreciation concepts. Under the useful life depreciation regime that existed before 1981 the actual useful life of a particular asset (the period over which an asset could reasonably be expected to be useful to a taxpayer in its business) played the key role in the calculation of depreciation. Under MACRS the recovery period of an asset generally is determined by placing it in a set of broad asset classes. These classes of assets are often depreciated over a shorter recovery period than actual economic useful life. In addition, under MACRS each recovery period is inextricably linked with a certain prescribed method of calculating depreciation (straight line, 150-percent declining balance, 200-percent declining balance). Taking cognizance of these differences, the Commissioner, through his administrative pronouncements, has determined that the distinctions between the useful life and recovery period concepts are more significant than their similarities and that a change in recovery period is not equivalent to a change in useful life. In Rev. Proc. 96-31, 1996-1 C.B. 714, the Commissioner stated that a change from not claiming the depreciation allowable to claiming the depreciation allowable is a change in method of accounting requiring consent. In IRS Pub. 538 (1993), the Commissioner expressly stated that a change in recovery period is a change in accounting method requiring his consent. See also section 2.01(2)(b)(vii) of the Appendix of Rev. Proc. 97-37, 1997-2 C.B. 455, 467 (“In contrast, section 2.01 of this APPENDIX generally applies to a change in recovery period of property for which depreciation is determined under § 168 or former § 168.”); Section 2.01(2)(b)(vii) of the Appendix of Rev. Proc. 98-60, 1998-2 C.B. 759, 772 (same); Section 2.01(2)(c)(vii) of the Appendix of Rev. Proc. 99-49, 1999-2 C.B. 725, 739 (“In contrast, section 2.01 of this APPENDIX generally applies to a change in recovery period of property for which depreciation is determined under § 56(a)(1), 56(g)(4)(A), 168 or former § 168.”); and Section 2.01(2)(c)(vii) of the Appendix of Rev. Proc. 2002-9, 2002-3 I.R.B. 327, 349 (same).

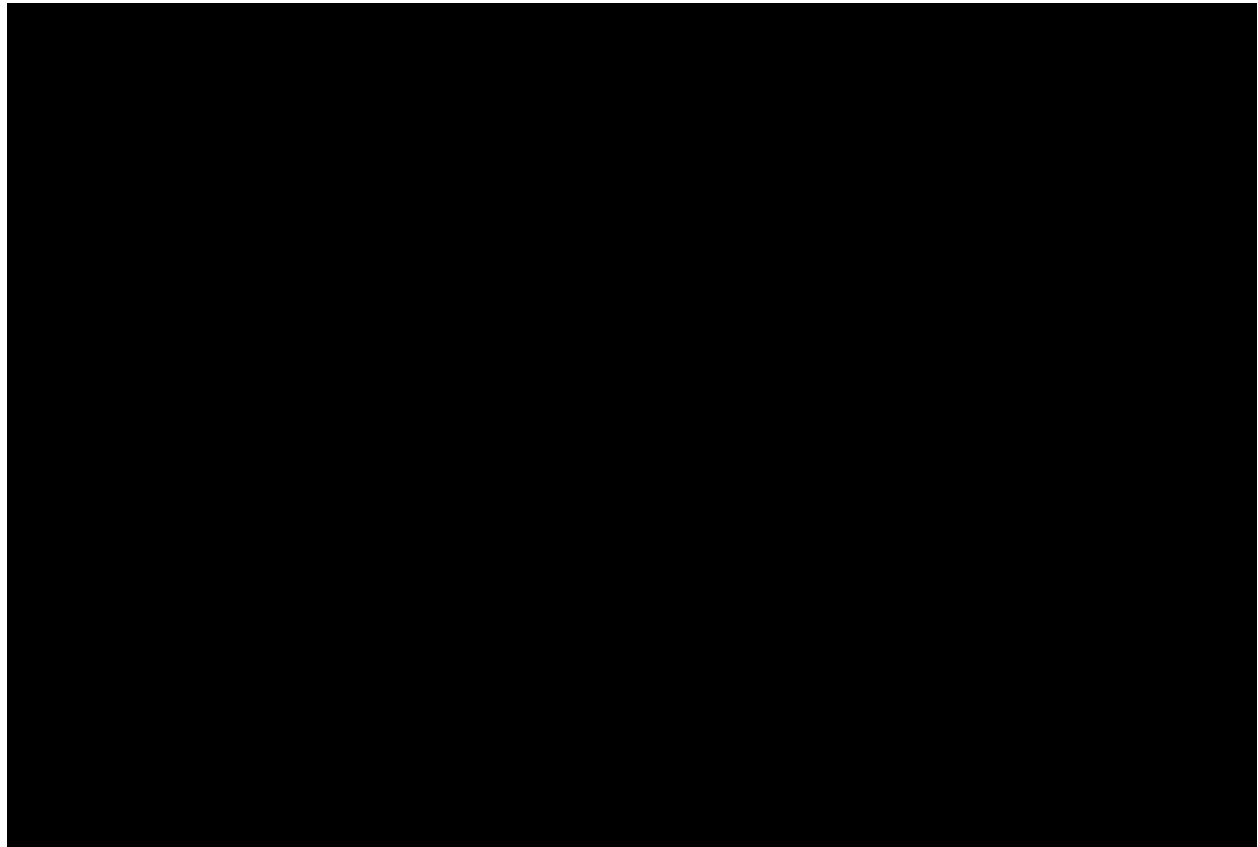
The scope of the useful life exception in section 1.446-1(e)(2)(ii)(b) was considered by the United States Court of Appeals for the Tenth Circuit in Kurzet v. Commissioner, 222 F.3d 830 (10th Cir. 2000). Noting that the Commissioner had promulgated administrative interpretations of the useful life exception (Rev. Proc. 96-31 and Pub. 538) that excluded a change in MACRS recovery period from that exception, the court stated that this interpretation is entitled to deference unless it is plainly erroneous or inconsistent with the regulation. The court concluded that the administrative pronouncements were entitled to deference, noting that the plain language of the regulation only excludes an adjustment of a change in the calculation of useful life. The United States District Court for the Western District of Texas in H. E. Butt Grocery Co. v. United States, 108 F. Supp. 2d 709 (W.D. Tex.

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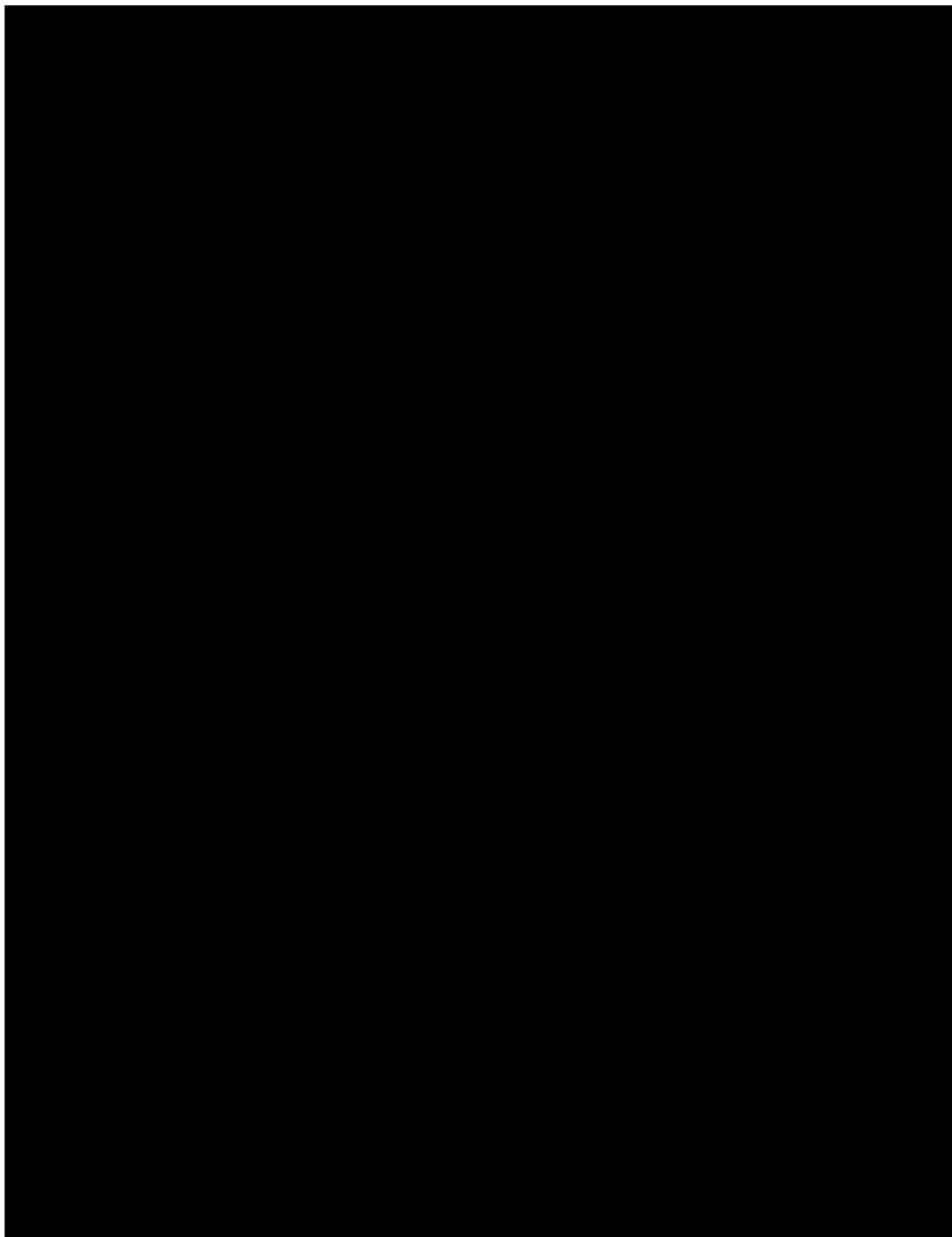
2000), and the United States District Court for the District of Minnesota in O'Shaughnessy v. Commissioner, 2002-1 USTC (CCH) ¶ 50,235 (D. Minn. 2001), also decided not to expand the useful life exception to property reclassifications under MACRS. However, see Brookshire Brothers Holding, Inc. and Subsidiaries v. Commissioner, T.C. Memo. 2001-150, appeal docketed, No. 01-60978 (5th Cir. Dec. 19, 2001), where the United States Tax Court expanded the useful life exception of section 1.446-1(e)(2)(ii)(b) to include MACRS property reclassifications.

Based upon the preceding discussion, we conclude that a change in recovery period does not fall within the scope of the limited exception provided by section 1.446-1(e)(2)(ii)(b). In the present case, the change in classification of the disputed assets changes the applicable recovery period and, consequently, the proper time that Taxpayer can take depreciation deductions. Section 1.446-1(e)(2)(ii)(a) provides that a change in the treatment of any item which involves the proper time for the taking of a deduction is a change in method of accounting. Accordingly, a change in recovery period resulting from a change in MACRS classification of the disputed assets is a change in method of accounting to which the provisions of section 446 and the regulations thereunder apply.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:



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If you have any questions regarding this Chief Counsel Advice, please call (202) 622-3110.

Mark Pitzer